No. 10373

In the United States Circuit Court of Appeals for the Ninth Circuit

MOHAWK PETROLEUM COMPANY, A CALIFORNIA CORPORATION, EDWIN V. MCKENZIE, AS EXECUTOR OF THE ESTATE OF ALFRED L. MARSTEN, DECEASED, EDWIN V. MCKENZIE, ALFRED L. MARSTEN, JR., AND LEWIS A. MARSTEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
SAMUEL H. LEVY,
ARTHUR MANELLA,
Special Assistants to the Attorney General.

INDEX

CITATIONS

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10373

Mohawk Petroleum Company, a California Corporation, Edwin V. McKenzie, as Executor of the Estate of Alfred L. Marsten, Deceased, Edwin V. McKenzie, Alfred L. Marsten, Jr., and Lewis A. Marsten, petitioners

v.

Commissioner of Internal Revenue, respondent

ON PETITION FOR REVIEW OF THE DECISIONS OF THE TAX COURT OF THE UNITED STATES

BRIEF FOR THE RESPONDENT

OPINION BELOW

The only previous opinion in this case is the opinion of the Tax Court (R. 67–83), which is reported in 47 B. T. A. 952.[1]

[1] With the proceeding involving Mohawk Petroleum Company, there were consolidated before the Board of Tax Appeals the proceedings of Alfred L. Marsten, Jr., Lewis A. Marsten, Edwin V. McKenzie, and Estate of Alfred L. Marsten, Deceased, Edwin V. McKenzie, Executor. The last named petitioners are admittedly transferees of the assets of the Mohawk Petroleum Company and liable, as such transferees, for any deficiencies determined against the Mohawk Petroleum Company, together with interest thereon as provided by law. (R. 67–68.)

JURISDICTION

This is a petition for review of federal income taxes for the fiscal years ended September 30, 1936, and September 30, 1937, in the amounts of $991.84 and $15,603.44, respectively. (R. 91.) The returns in respect of which the question of tax liability arises were filed with the Collector of Internal Revenue for the First District of California. (R. 92.) On October 4, 1940, the Commissioner mailed to taxpayer a notice of deficiency in the total amount of $16,595.28. (R. 13–14.) Within 90 days thereafter and on December 19, 1940, taxpayer filed a petition with the Board of Tax Appeals for a redetermination of that deficiency under the provisions of Section 272 of the Internal Revenue Code. (R. 7–13.) The decisions of the Tax Court of the United States [2] sustaining the Commissioner's determination were entered on November 4, 1942. (R. 84–88.) The case is brought to this Court by petition for review filed on January 29, 1943 (R. 90–102), pursuant to the provisions of Sections 1141–1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Whether taxpayer, having consistently taken depreciation on oil well equipment on the unit of production method based on the estimated oil reserves of a lease and the cost of all well equipment thereon, is entitled to a loss deduction under Section 23 (f)

[2] As of October 22, 1942, by Section 504 of the Revenue Act of 1942 the name of the Board of Tax Appeals was changed to the Tax Court of the United States.

of the Revenue Act of 1936 upon the retirement of equipment used in connection with an abandoned well on the lease, although production continued on the other wells.

2. Whether the Tax Court has jurisdiction to apply, under the principle of recoupment, an overpayment of tax in a year where no deficiency has been found against the deficiency in the taxable year before the Tax Court.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statutes and Treasury Regulations involved are set forth in the Appendix, *infra*, pp. 38–42.

STATEMENT

The facts as stipulated by the parties and found by the Tax Court are as follows (R. 49–58, 68–77):

The taxpayer, Mohawk Petroleum Company, was in the taxable years a California corporation and filed its returns with the Collector of Internal Revenue for the First District of California. The taxpayer has consistently closed its books and filed its income tax returns on the basis of a fiscal year ending September 30. (R. 68.)

The taxpayer acquired certain oil and gas leases upon lands in the Fruitvale Oil Field in Kern County, California, shortly after its organization in 1928. One of the leases so acquired was called the Red Ribbon Ranch lease. At the time of the acquisition of this lease there was a producing oil well located thereon.

Five additional wells were drilled on the Red Ribbon Ranch lease by taxpayer in 1929, 1930, and 1931, and all of the five wells became producing wells. All of the six wells located on the Red Ribbon Ranch lease continued to produce crude oil until during the fiscal year ended September 30, 1934, when one well became nonproductive. This well, taxpayer's Red Ribbon Ranch lease well No. 6, was finally abandoned in the fiscal year ended September 30, 1936. The other five wells located on the Red Ribbon Ranch lease continued to produce crude oil for several years after the year ended September 30, 1936. (R. 68–69.)

On December 12, 1932, the taxpayer entered into an oil and gas lease with E. B. and Frona McKeehan covering certain lands in the Weedpatch Oil Field in Kern County, California. During the fiscal year ended September 30, 1934, two producing oil wells were drilled on the McKeehan lease and during the fiscal year ended September 30, 1936, one producing oil well was drilled thereon. During the fiscal year ended September 30, 1937, wells Nos. 1 and 3 on the McKeehan lease became nonproductive and were abandoned. Well No. 2 on such lease continued to produce for several years after the fiscal year ended September 30, 1937. (R. 69.)

On March 17, 1936, the taxpayer entered into an oil and gas lease with the Earl Fruit Company, a corporation, covering certain lands in Kern County, California. During the fiscal year ended September 30, 1936, one oil well was completed on the Earl Fruit Company lease and during the fiscal year ended Sep-

tember 30, 1937, two additional wells were completed on that lease. Earl Fruit Company lease well No. 1 started production of crude oil in August, 1936, and became nonproductive in May, 1937, and was abandoned prior to September 30, 1937. Well No. 2 on the Earl Fruit Company lease was completed in January, 1937, but it was not a commercially productive well and was abandoned shortly after completion and the capitalized cost of the well was written off as a dry hole loss and allowed as such by the Commissioner in the fiscal year ended September 30, 1937. Earl Fruit Company lease well No. 3 was completed in March, 1937, and produced crude oil for several years after its completion. Two additional producing wells were later completed on this lease. (R. 69–70.)

Ever since its organization in 1928 taxpayer has consistently deducted intangible development costs in connection with drilling oil wells as expense and has capitalized the cost of tangible oil well equipment. The cost so capitalized of each well was set up separately in the taxpayer's books. The cost so capitalized applicable to the wells here in question is as follows (R. 70):

Red Ribbon Ranch Lease Well No. 6	$ 9,093.60
McKeehan Lease Well No. 1	22,304.17
McKeehan Lease Well No. 3	16,542.36
Earl Fruit Company Lease Well No. 1	15,735.91

Ever since its organization in 1928 taxpayer has consistently computed depreciation on the so-called unit of production method; that is to say, the annual depreciation applicable to the capitalized cost of oil well equipment located on a particular lease was de-

termined by dividing the capitalized cost (after a 10 per cent reduction for estimated salvage value) of all the wells on a particular lease by the estimated net potential crude oil production of the lease, and the unit cost per barrel thus determined was then multiplied by the net number of barrels produced during the year from that particular lease to arrive at the amount of depeciation for the year. Estimated oil reserves and resulting unit cost per barrel were for an entire lease and the estimate was based upon the aggregate potential production of all wells and no separate determination of unit cost as to each separate well was made. (R. 70–71.)

The depreciation reserve account in the taxpayer's general ledger relating to depreciation on the capitalized cost of its oil wells is segregated as between the depreciation applicable to each separate oil lease, but is not segregated as between each separate oil well located on a particular lease. (R. 71.)

Ever since its organization in 1928 taxpayer has maintained a record of the crude oil production of each separate oil well. (R. 71.)

During the fiscal year ended September 30, 1936, taxpayer wrote off as a loss consequent to the abandonment of its Red Ribbon well No. 6 in that year an amount of $5,044.13, which amount was computed as follows (R. 71–72):

Total cost of tangible equipment capitalized				$9,093.60
Less depreciation previously written off:				
Year ended—	Net bbls. produced after royalty to lessor—Red Ribbon Well No. 6	Unit deprecn. rate applicable to Red Ribbon Ranch lease well equipment	Amount	
Sept. 30, 1930	12,421	$0.032668392	$405.77	
Sept. 30, 1931	22,876	.032668392	747.32	
Sept. 30, 1932	41,285	.032971291	1,361.22	
Sept. 30, 1933	37,847	.032920749	1,245.95	
Sept. 30, 1934	8,785	.032920749	289.21	
Sept. 30, 1935	None		None	
Sept. 30, 1936	None		None	
Total				4,049.47
Abandonment loss				5,044.13

During the fiscal year ended September 30, 1937, taxpayer wrote off as losses consequent to the abandonment of its McKeehan wells Nos. 1 and 3 and its Earl Fruit Company well No. 1 a total amount of $35,026.52, which amount was computed as follows (R. 72–73):

LOSS ON MCKEEHAN WELL NO. 1

Total cost of tangible equipment capitalized				$22,304.17
Less depreciation previously written off:				
Year ended—	Net bbls. produced after royalty to lessor—McKeehan Well No. 1	Unit deprecn. rate applicable to McKeehan lease well equipment	Amount	
Sept. 30, 1934	105,426	$0.043556776	$4,592.02	
Sept. 30, 1935	114,161	.063458951	7,244.54	
Sept. 30, 1936	40,122	.063458951	2,546.10	
Sept. 30, 1937	8,300	.063458951	526.71	
Total				14,909.37
Loss on McKeehan Well No. 1				7,394.80

Loss on McKeehan Well No. 3

Total cost of tangible equipment capitalized				$16,542.36
Less salvage value of tangible equipment removed from well				1,479.75
Balance of equipment abandoned				15,062.61
Less depreciation previously written off:				
Year ended	Net bbls. produced after royalty to lessor—McKeehan Well No. 3	Unit deprecn. rate applicable to McKeehan lease well equipment	Amount	
Sept. 30, 1935	9,218	$0.063458951	584.96	
Sept. 30, 1936	5,938	.063458951	376.92	
Sept. 30, 1937	None			
Total				961.88
Loss on McKeehan Well No. 3				14,100.73

Loss on Earl Fruit Company Well No. 1

Total cost of tangible equipment capitalized	15,735.91
Less salvage value of tangible equipment removed from well	2,204.92
Balance	13,530.99
Depreciation previously written off	None

Taxpayer did not adjust the cost of well equipment on account of depreciation in its computation of loss on the abandonment of the Earl Fruit Company lease well No. 1 because at the time of closing its books for the fiscal year ended September 30, 1936, it had no reliable engineering reports as to the possible potential crude oil production from this lease and accordingly had insufficient data to compute depreciation with respect to the lease for the year and did not compute any depreciation in its books nor claim any depreciation in its income tax return with respect to the lease for the year. The Commissioner computed and allowed depreciation applicable to the well equip-

ment located on the Earl Fruit Company lease for the year ended September 30, 1936, as follows (R. 73–75):

	Total cost of tangible eqpt.	Less estimated salvage 10%	Balance subject to deprecn.	Unit cost (per bbl.) [1]	Net production after royalty to lessor (bbls.)	Deprecn.
Well No. 1	$15,735.91	$1,573.59	$14,162.32		2,884	
Well No. 2	4,003.29	400.33	3,602.96		None	
Total	19,739.20	1,973.92	17,765.28	$0.1188687	2,884	$342.82

[1] Based on total net potential production (after deduction of royalty to lessor) of 149,453 barrels of crude oil.

In his final determination of tax for the fiscal year ended September 30, 1936, the Commissioner disallowed the claimed deduction of $5,044.13 consequent to the abandonment of taxpayer's Red Ribbon Ranch lease well No. 6 and similarly disallowed during the fiscal year ended September 30, 1937, claimed deductions totaling $35,026.52 consequent to the abandonment of taxpayer's McKeehan lease wells Nos. 1 and 3 and Earl Fruit Company lease well No. 1, for the following reasons (R. 76–77):

> On your return you claimed the deduction of $5,044.13 in the fiscal year ended September 30, 1936 (and $35,026.52 in the fiscal year ended September 30, 1937) as a loss sustained through abandonment of oil well equipment at oil wells shut down during the taxable year although other wells on the same leaseholds continued to operate.
>
> You elected and have continued to deduct depreciation on your oil well equipment on your income tax returns on a unit of production based

upon the total estimated production of oil to be obtained from an entire leasehold.

Since your tangible oil well equipment installations on each leasehold in question consist of more than one installation and depreciation has been based upon the average lives of all such installations, losses claimed on the normal retirements of such assets are not allowable inasmuch as an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired or disposed of.

Therefore the losses claimed in the respective years are disallowed as deductions. See Article 23 (e)–3, Regulations 94 and 101.

The Commissioner's determination was upheld by the Tax Court. (R. 83.)

SUMMARY OF ARGUMENT

I

Taxpayer, having consistently taken depreciation on its oil well equipment on the unit of production method based on the estimated oil reserves of a lease and the cost of all equipment thereon, is not entitled to a loss deduction on the normal retirement of equipment used in connection with an abandoned well on the lease while the lease is producing from other wells located thereon. The rate of depreciation computed by taxpayer represents an average of the different rates that would have resulted had the reserves of each well

been separately estimated and applied to the cost of the particular equipment serving that well. By treating each lease hold and all the equipment serving that leasehold as a single economic unit, and readjusting the estimated oil reserves thereon in light of actual experience, taxpayer adopted a scheme which would not only return through depreciation allowances the cost of its assets in accordance with production, but which would also return the total cost of its investment when the last barrel of oil was extracted. There is therefore no room for permitting a loss deduction on the normal retirement of some assets in the group as long as other assets are still being used in connection with producing wells on the lease.

The claimed deduction should be denied in any event since there is nothing in the record to indicate that the well equipment in fact became permanently worthless during the taxable years involved. Although certain wells were abandoned, the equipment previously used at those wells might have been available for use elsewhere. Since taxpayer must affirmatively establish every element of its claimed deduction by presenting a case coming squarely within the applicable statute, its failure to do so precludes the allowance of its claim, irrespective of the theory asserted by the Commissioner in denying the deduction.

II

In redetermining the amount of any deficiency for a taxable year before it, the Tax Court has no jurisdiction to determine whether or not the tax for any

other taxable year has been overpaid. Therefore, the deficiency resulting from disallowance of the claimed retirement losses for the taxable years before the Tax Court should not be reduced by recouping against that deficiency the amount by which taxpayer might have overpaid its taxes for a taxable year not before the Tax Court.

ARGUMENT

I

The Tax Court correctly concluded that the taxpayer was not entitled to the retirement losses claimed on equipment used in connection with its abandoned oil wells

We are here concerned with the question of whether taxpayer is entitled to a loss deduction for the undepreciated cost (less salvage value) of certain oil well equipment used in connection with four wells which it had been operating under three separate oil leases, and which wells it had abandoned during the taxable years involved.

1. Since the present case involves a group of assets, the depreciation on which taxpayer had computed by means of a composite rate, it would seem expedient at the outset to examine briefly some of the general principles applicable to composite rates of depreciation. Article 23 (e)–3 of Treasury Regulations 94 (Appendix, *infra*), provides that if the depreciable assets of a taxpayer consist of more than one item and depreciation in respect of those items is based upon their average lives, losses claimed on the normal retirement of such assets are not allowable. The theory of such a rule is, as the Regulations point out, that

the use of an average rate[3] contemplates a normal retirement of assets both before and after the average life has been reached, and there is, therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired.

The precise situation as above described was presented in *U. S. Industrial Alcohol Co.* v. *Commissioner,* 42 B. T. A. 1323, appeal pending in the Circuit Court of Appeals for the Second Circuit.[4] There the composite rate was arrived at by taking the average anticipated normal life of the various assets comprising the group to which the rate was applied. In such case, assets which are retired at the end of their normal life will not be permitted to furnish further compensation by means of a deduction for loss on retirement, even though they are retired in advance of the average life of the entire group, because of the fact that their early retirement will be compensated for by depreciation taken after the average period has passed.

The principle and the method of its application can be explained in no better language than was employed

[3] A taxpayer attacking a composite rate determined by the Commissioner must show error in the average before it can be said that the rate is not reasonable. Proving a shorter life for some items in the group is not enough. *Southern California F. Lines* v. *Commissioner*, 99 F. 2d 104 (C. C. A. 9th).

[4] On appeal there was no dispute concerning the correctness of the basic principle that losses on the normal retirement of assets are not allowable where a composite rate of depreciation based on the average lives of those assets is used.

by the Board of Tax Appeals in its decision in the *Alcohol* case. To quote from that opinion (pp. 1375–76):

> A composite rate may be arrived at by taking average depreciation based upon the anticipated life of the assets concerned, weighted for their respective costs. The resulting rate is then applied to the entire group of assets involved. This method of computation produces a convenient rule of thumb for calculating depreciation on a large number of assets, and if properly applied minimizes the possibility of double deductions. The latter requisite must constantly be adhered to in the application of methods of depreciation. *Illinois Pipe Line Co.,* 37 B. T. A. 1070, 1081.
>
> Under this theory of a composite rate it is proper to eliminate from the base the cost of assets as they arrive at the end of their useful lives. This results from the fact that the composite rate is an average and that some assets will actaully have a shorter and some a longer period of existence than the useful life appropriate to that average. Only if the base is constantly reduced by the cost of the assets removed from it as they reach the end of their anticipated useful life will it be possible for the owner to continue to take depreciation deductions beyond the median point and while some of the longer lived assets are still necessarily being usefully employed.
>
> A simple illustration will suffice. Assume five assets, each of the same cost basis, having anticipated useful lives of one through five

years. The average life will be three years. On the theory that this calls for a depreciation rate of 33⅓ percent, that is also the weighted average since the costs are identical. Depreciation taken on the full original cost basis would exhaust the total investment at the end of three years and no depreciation would be allowable after that time, even though some of the assets would, by hypothesis, remain in use during the fourth and fifth years. Thus, for almost half the time the taxpayer would be deprived of an annual deduction for depreciation. If, however, the cost basis is reduced each year as one of the assets is removed from the group by reason of normal retirement, and, assuming no replacements, the gradually diminishing base and hence the reduced amount of depreciation will enable the taxpayer to continue to depreciate the assets remaining in each year at the composite rate throughout the fifth year and the result will be an exact recovery at that time of the original cost of all the assets.

The situation involved in the *Alcohol* case may perhaps be further clarified by reference to a table of computations. Assume, as the Board suggested, five assets, each with the same cost basis of $20,[5] having anticipated normal useful lives of one through five years, i. e., one asset will be retired at the end of each year. The average life of these five assets is three

[5] For the sake of convenience, in all cited examples the problem of weighting is taken care of by assuming that all assets have the same cost basis. Salvage value is also disregarded for purposes of simplification.

531336—43——3

years. The depreciation rate, computed upon the basis of average life, will then be 33⅓ per cent.

EXAMPLE 1

Years	Capital	Rate of depreciation (percent)	Amount of depreciation
1	100	33⅓	33.33
2	80	33⅓	26.67
3	60	33⅓	20.00
4	40	33⅓	13.33
5	20	33⅓	6.67
	[1] 100		[2] 100.00

[1] Capital lost.
[2] Capital recovered through depreciation.

An entirely different situation is presented, however, if the composite rate used, rather than being based on the average lives of the assets in the group, is based instead upon the life of the longest lived asset in the group. *Illinois Pipe Line Co.* v. *Commissioner,* 37 B. T. A. 1070, involved such a case. There the taxpayer had deducted depreciation at a uniform rate on oil pipe lines, based upon the estimated economic lives of the oil fields which those lines served. When an asset was retired through abandonment or other disposition, the gross cost of the asset was eliminated from the asset account and the accumulated depreciation thereon was eliminated from the appropriate reserve account which was maintained for each class of assets. Any excess of cost over accumulated depreciation and salvage value was deducted as a loss on retirement. The Board of Tax Appeals ruled that the losses on retirements were properly deductible because the taxpayer's method, consistently applied, would fully return to the taxpayer its capital investment over the

period of the economic life of the equipment, would not result in any double deduction, and would not distort income for any year. Since the depreciation rate in the *Pipe Line* case was based upon the maximum economic life of the properties, any assets having a useful life less than the maximum life period used in computing the depreciation rate, and having served to reduce the basis upon which depreciation was computed when such assets were retired, would obviously be retired at a loss to the extent of their undepreciated cost. Unlike the situation in the *Alcohol* case, assets retired before the period upon which the depreciation rate is based would not be compensated for by depreciation taken after that period had passed. In the *Pipe Line* case, when the five-year period had passed, there would be no further depreciation to be taken. As the Board of Tax Appeals said in *U. S. Industrial Alcohol Co.* v. *Commissioner, supra,* in explaining its decision in the *Illinois Pipe Line* case (p. 1377):

> The 5 percent rate used there was arrived at by assuming a 20-year life for all of the assets. It was the result of an anticipated destruction at the end of 20 years of the oil fields which were being served by the pipe line. It is evident that none of the assets under those circumstances could have had a useful economic life longer than 20 years, and, since the rate adopted was 5 percent, assets having a shorter life than 20 years would be retired at a loss. Thus the depreciation there, and the deductions, being calculated upon the maximum economic life of the entire plant, not the average life of separate assets, the loss deduction was proper.

Thus Article 23 (e)–3 of the applicable Regulations in recognizing the soundness of the principles as above discussed, provides that only where a taxpayer has consistently computed depreciation on a composite rate based on the expected life of the longest lived asset contained in the group to which the rate is applied, will a loss deduction for the basis of the asset (generally its undepreciated cost) less its salvage value be allowed upon its retirement.

The situation presented by the *Pipe Line* case and the manner in which it differs from the *Alcohol* case can best be illustrated by a table. Assume, as previously, a taxpayer with a group of five assets, each asset costing $20, and that during this five-year period one asset is retired at the end of each year due to normal depreciation. Assume here, however, that the depreciation rate, rather than being computed on the average life of the assets in the group, is computed on the basis of the longest lived asset, i. e., five years, or 20 per cent. The result would be as follows:

Example 2

Years	Capital	Rate of depreciation (percent)	Amount of depreciation	Depreciation on asset retired	Loss on asset retired	Cost of asset retired
1	100	20	20	4	16	20
2	80	20	16	8	12	20
3	60	20	12	12	8	20
4	40	20	8	16	4	20
5	20	20	4	20	0	20
	[1] 100		[2] 60		[3] 40	

[1] Capital lost.
[2] Capital recovered through depreciation.
[3] Capital recovered through loss deduction.

An examination of the above table makes it clear that before a loss for the normal retirement of assets may be properly claimed within the principle of the *Pipe Line* case, at least two conditions must be met: (1) The composite rate of depreciation must be based on the expected life of the longest lived asset in the group, and (2) the rate of depreciation so obtained must be continued to be applied, even though as assets are retired experience makes it clear that some of the assets in the group in fact have a life shorter than the estimated life upon which the depreciation rate was computed.

To clarify the second condition mentioned—if, even though the composite depreciation rate is originally computed upon the basis of the expected life of the longest lived asset in the group, that rate is subsequently adjusted each year in light of actual experience as to the life of each asset, no deduction for retirement losses will be permitted, since the adjusted depreciation rate will in future years succeed in fully depreciating the total cost of each asset. That is, at the end of the useful life of the longest lived asset in the group, the cost basis of each asset will have been fully recovered through depreciation. Thus, in the example mentioned above, assume that the taxpayer having originally determined the depreciation rate on the basis of the expected life of the longest lived asset, i. e., five years, or 20 per cent, redetermines that rate at the end of the first year when the first asset is retired, on the basis that the maximum life of the longest

lived asset is now only four years, and redetermines the rate again at the end of the second year on the basis that the maximum life of the longest lived asset is now three years, and so on each year. In such case the result would be as follows:

EXAMPLE 3

Years	Capital	Rate of depreciation	Amount of depreciation
1	100	20% (5 years)	20
2	80	25% (4 years)	20
3	60	33⅓% (3 years)	20
4	40	50% (2 years)	20
5	20	100% (1 year)	20
	[1] 100		[2] 100

[1] Capital loss.
[2] Capital recovered through depreciation.

The constant adjustment of the depreciation rate to accord with actual experience means that during the first year the rate was based on a five-year life, during the second year on a four-year life, during the third year on a three-year life, the fourth year on a two-year life, and the fifth year on a one-year life. The taxpayer therefore has not consistently based the rate of depreciation on the expected life of the longest-lived asset in the group, i. e., five years, but has, in effect, determined the depreciation rate upon the average life of the five assets, i. e., three years. The situation in Example 3 thus more nearly resembles Example 1, both methods of computation providing for full recovery of taxpayer's total investment through depreciation by the time the last asset is exhausted and there-

fore permitting no loss deductions during the years the assets are normally retired.[6]

2. The present case differs from any of the situations heretofore discussed in that here the rate of depreciation was computed not with regard to the estimated lives of the various depreciating assets, but by the so-called unit-of-production method. The rate of depreciation to be applied to each barrel of oil recovered from each leasehold was determined by dividing the total cost of all the physical equipment (less salvage) serving that leasehold by the estimated future production of the leasehold. The unit rate thus determined was then multiplied by the number of barrels of oil produced during the year from the particular lease to arrive at the amount of depreciation for the year. Taxpayer argues that the method of depreciation adopted by it brings it within the principle of the *Pipe Line* case and that the loss deduction claimed should, therefore, be permitted. We submit that the principle of that case can have no application here.[7]

[6] The difference in the yearly amounts of depreciation as computed under the methods illustrated in Example 1 and Example 3 is, of course, due to the fact that in the former a fixed rate of depreciation is applied to a diminishing base, whereas in the latter an increasing rate is applied to a proportionately diminishing rate, resulting in a constant amount of depreciation. The net effect of both methods, however, is precisely the same.

[7] Taxpayer also asserts (Br. 12), as an alternative theory (though it does not seriously press the argument), that the deduction claimed should be permitted because the retired assets in question actually lived less than their "normal" lives, that is, less than they would have lived had they undergone only wear and tear and normal obsolescence. It is true that Article 23 (e)–3 of Regulations 94 provides that where depreciable property is disposed of due to causes other than exhaustion, wear and tear, and

As previously pointed out, the theory of the *Pipe Line* case is that where a fixed composite rate of depreciation is computed on the basis of the expected life of the longest-lived asset in the group and continually applied, a deduction for assets retired before that time is permitted because such loss will not be compensated for by depreciation taken after that time. Only by permitting the loss deduction can a taxpayer in such a case fully recover his capital investment when the last of the assets is exhausted. By no stretch of the imagination can a comparable situation be said to exist here. In the instant case taxpayer did not estimate the oil reserve of each individual well and compute its depreciation rate upon the basis of that estimate coupled with the cost of the equipment of that particular well. Rather, in computing its depreciation rate, taxpayer based that rate upon the total estimated production of oil to be obtained from an entire leasehold and upon the total cost of all the equipment of the various wells serving that leasehold. By so doing it allocated to each barrel of oil recovered from the entire leasehold a pro rata share of the total cost of *all* the equipment serving the leasehold, ir-

---

normal obsolescence, such as casualty, abnormal obsolescence, or sale, and where it is clearly evident that such disposition was not contemplated in the rate of depreciation, a loss deduction for the asset disposed of is permitted. However, there was absolutely no evidence offered by taxpayer, nor is there anything in the record to indicate, that the well equipment in question was disposed of due to causes other than wear and tear and normal obsolescence. An examination of the record in *Mason City Brick & Tile Co.* v. *Huston*, 36 F. Supp. 515 (N. D. Iowa), relied on by taxpayer, reveals that the property there, unlike the assets here involved, was retired because of abnormal obsolescence.

respective of to what extent each piece of equipment actually served to produce that barrel of oil and even though a particular part of that group of equipment may have contributed not at all to the production of that oil. In other words, taxpayer chose to treat each leasehold and the entire equipment serving that leasehold as a single economic unit. By so doing it adopted a scheme which consistently provided for an equitable portion of the cost of the entire equipment to be spread ratably over each and every barrel of oil produced by the property, and a scheme which would not only return through depreciation allowances the capital invested in accordance with production, but which would return, when the last barrel of oil was extracted, every cent which had gone into producing that oil.

It is obvious, of course, that had taxpayer chosen to compute a single depreciation rate for the equipment on each well, based upon the estimated production of that well, the total depreciation taken during each year of operation would have been much different from the yearly depreciation allowances resulting from the method chosen. Thus if in taxpayer's Examples F and G (Br. 25), it had originally estimated the reserves of each well separately and determined a separate rate of depreciation for each well, a mathematical computation will reveal that total depreciation on the equipment of the six wells during the first three years would have been $12,000 each year, not $9,000, and that depreciation on the remaining equipment after three wells had been abandoned at the end of

the third year would thereafter have been $6,000 per year for the last three years.[8] But by treating each leasehold and the equipment thereon as a single economic unit and basing its depreciation rate on that unit as a whole, taxpayer chose to adopt a method that would level off its depreciation cost irrespective of the fact that the reserves of some wells on that particular leasehold might be less (and the depreciation rate therefore greater) than other wells, and irrespective of the fact that some wells would therefore be retired before others. By estimating total reserves for the entire leasehold, taxpayer arrived at a rate of depreciation that represents an average of the different rates that would have resulted had the reserves of each well been separately estimated and applied to

[8] Thus if a separate depreciation rate had been applied to the equipment on each well on the basis of that well's estimated reserves, the result would be as follows:

(a) For the three wells abandoned at the end of the third year:

	A Original cost less prior depreciation	B Amount of depreciation	C Production per year in barrels	D Oil reserves	E Rate (A÷D) *(cents)*
1st year	27,000	9,000	180,000	540,000	5
2d year	18,000	9,000	180,000	360,000	5
3d year	9,000	9,000	180,000	180,000	5
		27,000	540,000		

(b) For the three wells which operated for six years:

	A	B	C	D	E
1st year	27,000	3,000	180,000	1,620,000	1.66⅔
2d year	24,000	3,000	180,000	1,440,000	1.66⅔
3d year	21,000	3,000	180,000	1,260,000	1.66⅔
4th year	18,000	6,000	360,000	1,080,000	1.66⅔
5th year	12,000	6,000	360,000	720,000	1.66⅔
6th year	6,000	6,000	360,000	360,000	1.66⅔
		27,000	1,620,000		

the cost of the particular equipment used at that well.[9] By applying an average rate of depreciation to the equipment of all the wells, the lesser amount of depreciation taken during the early years than would have been taken had the reserves of each well been computed separately is exactly compensated for in later years by the greater amount of depreciation taken than would have been taken had reserves of each well been separately computed.

Thus taxpayer, having chosen to treat all of the wells on an entire leasehold as a single economic unit, should not now be permitted to abandon that method and distort its income for a particular year by taking loss deductions as parts of that unit are retired. Cf. *Pacific National Co.* v. *Welch,* 304 U. S. 191; *St. Paul Union Depot Co.* v. *Commissioner,* 123 F. 2d 235 (C. C. A. 8th). As long as the economic unit is still producing oil, taxpayer suffers no loss from the retirement of a particular well. It will through depreciation allowances be fully compensated for the total cost of its entire investment in that unit, when the last barrel of oil is extracted. In short, the method adopted by taxpayer is predicated upon precisely the same principle as the situation where a composite rate of depreciation based on the average lives of a group of assets is used. See *U. S. Industrial Alcohol Co.* v. *Commissioner, supra.* In both instances the method

[9] If the reserves of each well were computed separately, the equipment of those wells containing smaller estimated reserves (and which would therefore normally be retired before those with larger reserves) would be depreciated at a larger unit rate of depreciation.

adopted employs a rate which represents an average of the rates which would have been adopted had each asset been treated separately. In both instances the method adopted contemplates that some of the assets will normally be retired before and after the median factor upon which the rate was computed, and in both instances the method adopted will, by the time the last asset in the unit is retired, have returned to the taxpayer through depreciation allowances the full cost of its investment in all of the assets. In neither case, therefore, should a loss claimed for normal retirement in order to increase the amount of deductions for a particular year be permitted to thus distort income for that year as long as all the assets in the group have not been retired.[10]

It is also significant to note that the estimated oil reserves used by the taxpayer in figuring its depreciation rate represented not the absolute maximum reserves which a particular oil field was estimated to contain, but on the contrary represented the considered judgment based on sound business policy of what taxpayer believed the entire field would probably produce. The estimate, rather than being the maximum

[10] The Commissioner has here determined that the method of accounting employed by taxpayer will clearly reflect its income only if the loss claimed on the normal retirement of assets is not permitted. The Tax Court affirmed that determination. The interpretation of the statute and the practice adopted by the administrative board charged with the duty of enforcing the Act should not be interfered with unless clearly unlawful. *Lucas* v. *American Code Co.*, 280 U. S. 445, 449: "It is not the province of the court to weigh and determine the relative merits of systems of accounting." *Brown* v. *Helvering*, 291 U. S. 193, 205.

amount of oil that could be expected to be recovered, probably represents more nearly the minimum estimated reserves. But in any event it clearly represents no more than the *average* estimated reserves, that is, a figure approximately half way between the estimated minimum and the estimated maximum reserves. As a matter of fact, taxpayer's position would not be improved even if it had established (which it has not) that its original estimate of oil reserves was based upon what was thought to be the absolute maximum amount of oil that could possibly be produced from a particular field. For while such a method of determining the depreciation rate might at first blush seem comparable to that employed in *Illinois Pipe Line Co.* v. *Commissioner, supra,* where the maximum life of the longest lived asset was used as the basis for determining the depreciation rate, in this case, unlike in the *Pipe Line* case, the estimate of future oil reserves was constantly revised in the light of later experience to determine a new rate each year.[11] As the *Pipe Line* and *Alcohol* cases and applicable Treasury Regulations clearly illustrate, a loss deduction for the normal retirement of assets depreciated through composite rates should be permitted only in those instances where to refuse such deduction would mean

[11] Had the depreciation rate been originally computed on the basis of the absolute maximum estimated reserves which a particular field might contain, and such estimated reserves never subsequently scaled down to coincide ultimately with actual reserves, only then would the full cost of all the assets not be recovered through depreciation allowances when the last barrel of oil was extracted.

that when the last asset is fully depreciated the total cost of all the assets comprising the group will not have been recovered through depreciation allowances. Such a situation exists, as the Regulations recognize, only where the composite depreciation rate, computed on the life of the maximum lived asset in the group, is continually applied without variation or adjustment. Of necessity, such situation cannot exist, as previously pointed out in Example 3, where the factors upon the basis of which the depreciation rate is determined is consistently reconsidered and adjusted each year to accord with actual experience. In the instant case "A new depreciation rate was computed whenever additional wells or additional capital items were added to existing wells during a year, or when it became appropriate, because of production experience, to increase or decrease the estimate of the remaining recoverable barrels of oil from a particular lease." (Pet. Br. 10.) That is, the estimate of future oil reserves was "corrected from year to year as experience * * * [showed] it to be too high or low and corrected finally to the actual barrels of oil produced." (Pet. Br. 30.) But in the *Pipe Line* case the depreciation rate, having been originally determined on the basis of the longest lived asset in the group, "was never adjusted." (Pet. Br. 20.) In no way can it be said, as taxpayer contends, that "that mode of determination is in legal effect the same as that used by Petitioner." (Br. 20.) On the contrary, here, just as in the case of Example 3, *supra,*

and unlike the *Pipe Line* case, the constant readjustment of taxpayer's depreciation rate will permit it to recover through depreciation the full cost of its investment in all of its assets when the estimated oil reserve is recovered. No deduction for loss upon the normal retirement of assets is therefore necessary or proper.

Despite taxpayer's assertion that its method of depreciation "presupposes that all of the equipment will last the life of * * * the oil lease" (Br. 2), it seems manifest that this is not the case. Rather it seems clear that it was contemplated that some of the wells would cease production before all of the oil from the entire field was recovered. Far from it being unusual that some of the wells should cease production before all the oil was recovered, it would on the contrary be most unusual if all the wells continued production up until the precise moment when the last barrel of oil to be recovered was finally extracted. As the Tax Court pointed out, "The fallacy of petitioner's argument lies in the fact that it presupposes the life of the tangible equipment of a well to be coextensive with the life of the lease or so long as the lease on which the wells are located is productive." (R. 78–79.) Just as in the case where a composite depreciation rate based on the average lives of a group of assets contemplates a normal retirement of assets both before and after the average life has been reached, so here the use of an average composite rate of depreciation based upon the combined oil reserves and total

cost of all the equipment applicable to a particular leasehold does likewise.[12]

3. Moreover, as the Tax Court recognized, apart from any other considerations, taxpayer's claimed deduction must be denied here since there is absolutely nothing in the record to indicate that the well equipment in question had actually become worthless during the taxable years. Since losses are allowable only on closed and completed transactions, no deduction for a claimed loss will be permitted unless it is clear that the property in question has in fact become worthless during the year the loss is claimed. *Lucas* v. *American Code Co.*, 280 U. S. 445; *United States* v. *White Dental Co.*, 274 U. S. 398; *Lambert* v. *Commissioner*, 108 F. 2d 624 (C. C. A. 10th); *De Loss* v. *Commissioner*, 28 F. 2d 803 (C. C. A. 2d), certiorari denied, 279 U. S. 840. Treasury Regulations 94, Article 23 (e)–3. Despite taxpayer's assertion to the contrary, the stipula-

[12] *Witherspoon Oil Co.* v. *Commissioner*, 34 B. T. A. 1130, relied on by taxpayer, apart from being distinguishable, as the Tax Court in the instant case pointed out, on the ground that the deduction claimed for the undepreciated cost of the assets involved was never questioned, is also distinguishable on another ground. In that case the years in controversy were 1924 to 1926, inclusive. The Regulations applicable to those years, Article 143 of Treasury Regulations 65 and 69, contained no prohibition against the deduction of losses claimed on the normal retirement of assets to which an average composite rate of depreciation is applied. The prohibition first appeared in Article 23 (e)–3 of Regulations 86, promulgated under the Revenue Act of 1934. This article was amended by T. D. 4612, XIV–2 Cum. Bull. 99, approved December 11, 1935, and as thus amended has been repeated in Article 23 (e)–3 of Regulations 94, 101 and Section 19.23 (e)–3 of Regulations 103. See also Mim. 4170, XII–1 Cum. Bull. 59, 61–62 (1934); Mim. 4170 (Rev.), XV–2 Cum. Bull. 148, 150–151 (1936).

tion between the parties did not declare that the "well equipment" had been abandoned because of its economic worthlessness. The stipulation merely shows that certain wells "became nonproductive and were abandoned. (R. 50.) But clearly there is nothing in the nature of oil well equipment which necessarily renders it permanently worthless simply because a particular well at which the equipment is being used proves unproductive. As the Tax Court observed in pointing out that the well equipment itself might be, and often is, available for use at other wells (R. 79):

> The fact that a well becomes nonproductive and is abandoned does not necessarily result in the complete loss of usefulness of the equipment thereon or accelerate its depreciation or constitute abnormal retirement of the equipment. Such equipment may be and often is used at other wells. The stipulation shows that the wells involved were abandoned, but there is no evidence showing that the equipment thereon was also abandoned because it had lost its usefulness or that the abandonment of the wells caused depreciation of the equipment in excess of that normally sustained. Except that the stipulation shows that petitioner "wrote off" the amounts of $5,044.13 and $35,026.52 "as losses consequent to the abandonment of its" wells and claimed losses on its income tax returns in such amounts, there is no evidence that the equipment was actually retired or abandoned because it had lost its economic usefulness and had no more than scrap or salvage value or no value.

Nor is taxpayer's position improved by its complaint that it was unable to anticipate the Tax Court's decision

as to this point and was misled by the fact that the Commissioner had raised but one issue in his deficiency letter. (Br. 43.) Since deductions are a matter of legislative grace (*New Colonial Co.* v. *Helvering,* 292 U. S. 435, 440), before the Tax Court the burden is upon the taxpayer "to show that it was entitled to the deduction which the Commissioner had disallowed and that the additional tax was to that extent illegally assessed." *Reinecke* v. *Spalding,* 280 U. S. 227, 233; *Welch* v. *Helvering,* 290 U. S. 111. To sustain its burden taxpayer must establish every element of its claim by presenting a case that comes squarely within the terms of the statute. *New Colonial Co.* v. *Helvering, supra; White* v. *United States,* 305 U. S. 281, 292. As a corollary of this, it has been consistently held that the Tax Court is not bound by the reason assigned by the Commissioner in denying the deduction claimed. "If the disallowance is right it must be affirmed by the application of the correct rule of law" (*Acer Realty Co.* v. *Commissioner,* 132 F. 2d 512 (C. C. A. 8th), irrespective of the theory asserted by the Commissioner. See also *Helvering* v. *Gowran,* 302 U. S. 238; *Crowell* v. *Commissioner,* 62 F. 2d 51 (C. C. A. 6th); *Alexander Sprunt & Son* v. *Commissioner,* 64 F. 2d 424, 427 (C. C. A. 4th); *J. & O. Altschul Tobacco Co.* v. *Commissioner,* 42 F. 2d 609, 610 (C. C. A. 5th); *Standard Oil Co.* v. *Commissioner,* 43 B. T. A. 973, 998, affirmed, 129 F. 2d 363 (C. C. A. 7th). Having failed to sustain the burden of proving that the well equipment in question actually became permanently worthless during the taxable year, taxpayer's claim for a loss deduction must be denied.

II

The Tax Court has no jurisdiction to apply under the principle of recoupment, an overpayment of tax in a year where no deficiency has been found by the Commissioner against the deficiency in tax of the year before the Tax Court

Taxpayer also argues that even should this Court sustain the action of the Tax Court and deny the loss deductions claimed for the taxable years 1936 and 1937, it is, nevertheless, entitled to recoup against the deficiency for those years the sum of $5,660.87, which sum represents the overpayment of its taxes for the year 1938, and which it is barred by the statute of limitations from recovering in any refund action. Taxpayer's claim for recoupment is predicated upon its assertion that the $5,660.87 overpayment for the year 1938 was occasioned by, and is the result of, the Commissioner's disallowing the loss deductions claimed for 1936 and 1937, the taxable years in controversy. Taxpayer, in pressing the doctrine of equitable recoupment, relies primarily upon the decision of the Circuit Court of Appeals for the Eighth Circuit in *Gooch Milling & Elevator Co.* v. *Commissioner,* 133 F. 2d 131.[13] Petition for a writ of certiorari has been

[13] The basis of the decision in the *Gooch Milling Company* case, as the court there pointed out, was that the same fact, i. e., the inventory adjustment, which established a deficiency for the year in controversy automatically established an overpayment for the year sought to be offset against that deficiency. While taxpayer, in relying upon that decisoon, alleges that the $5,660.87 overpayment in its taxes for the year 1938 was occasioned solely as the result of the Commissioner's disallowing the loss deductions here in issue for the taxable years 1936 and 1937, the facts do not appear to support this assertion. The record reveals that the overpay-

filed by the Government in the *Gooch Milling Company* case, and to the extent that that decision may be applicable here, we respectfully submit that it was incorrectly decided.

The only taxable years before the Tax Court in the instant case were the fiscal years ended September 30, 1936, and 1937. The taxable year ended September 30, 1938, is not here involved. Under these circumstances the taxpayer invokes the doctrine of equitable recoupment in an attempt to have the Tax Court determine an overpayment of tax for the fiscal year 1938, a year not before the Tax Court for determination, and to offset that overpayment against deficiencies in tax for the fiscal years ended September 30, 1936, and 1937, in an appeal properly before the Tax Court.

The Tax Court [14] is a tribunal whose jurisdiction is limited by statute to the taxable year in which a

---

ment of $5,660.87 for the year 1938 was due to taxpayer's reporting a capital gain realized from the sale of certain of its assets at a figure of $134,453.89 in excess of the true capital gain. (R. 27.) Included in this total adjustment of $134,453.89 were the amounts of $5,044.13 and $35,026.52, resulting from the disallowance of the loss deductions here in controversy. (R. 29–30.) It seems clear, therefore, that the $5,660.87 overpayment for 1938 was due *only in part* to the Commissioner's disallowance of the loss deductions claimed here. To the extent of $94,383.94 ($134,453.89 − $5,044.13 − $35,026.52) taxpayer's income for 1938 was reduced as the result of adjustments in no way related to the loss deductions involved in the instant case. To the extent, therefore, that the overpayment of $5,660.87 was due to the adjustment of taxpayer's income for 1938 in the amount of $94,383.94, the decision in the *Gooch Milling Company* case can have no application here.

[14] The name of the Board of Tax Appeals was changed to The Tax Court of the United States, effective October 22, 1942, by Section 504 (a) of the Revenue Act of 1942, Public Law 753, 77th

notice of deficiency in tax has been mailed by the Commissioner and a petition has been filed by the taxpayer with the Tax Court. Section 272 (a) of the Revenue Act of 1936 (Appendix, *infra*); *U. S. ex rel. Girard Co.* v. *Helvering,* 301 U. S. 540, 542. The Tax Court may determine an overpayment in tax only in respect of a taxable year in which the Commissioner has determined a deficiency in tax. *U. S. ex rel. Girard Co.* v. *Helvering, supra; Morrison Woolen Co.* v. *Commissioner,* 10 B. T. A. 8, 9; *Stanfield* v. *Commissioner,* 8 B. T. A. 787, 819. The Tax Court has no jurisdiction unless a deficiency in tax is found by the Commissioner. Section 322 (d) of the Revenue Act of 1936 (Appendix, *infra*). The Board in redetermining a deficiency in respect of any taxable year is authorized to consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, "but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid." Section 272 (g) of the Revenue Act of 1936 (Appendix, *infra*); *Commissioner* v. *Forest Glen C. Co.,* 98 F. 2d 968 (C. C. A. 7th), certiorari denied, 306 U. S. 639; *Greenleaf Textile Corp.* v. *Commissioner,* 26 B. T. A. 737, affirmed, 65 F. 2d 1017 (C. C. A. 2d).

Cong., 2d Sess., amending Section 1100 of the Internal Revenue Code. But Section 504 (b) of the Revenue Act of 1942 provided that the jurisdiction powers and duties shall be the same as provided by existing law in the case of the Board of Tax Appeals. See H. Rep. No. 2333, 77th Cong., 2d Sess., pp. 172–173; H. Conference Rep. No. 2586, 77th Cong., 2d Sess., p. 40.

The decision of the Supreme Court in *U. S. ex rel. Girard Co.* v. *Helvering,* 301 U. S. 540, recognizes that the Board of Tax Appeals does not have jurisdiction to allow a recoupment as taxpayer here contends. The Supreme Court there held that the Board was without jurisdiction to order a refund or credit of overpayment of taxes, but rather was limited to the determination of the amount of the deficiency or overpayment upon the petition of the taxpayer to review a deficiency in tax found by the Commissioner. In point also is *Commissioner* v. *Forest Glen C. Co.,* 98 F. 2d 968 (C. C. A. 7th), certiorari denied, 306 U. S. 639, in which it was held that where the Commissioner had determined a deficiency in tax for one taxable year, the Board on appeal to it from such determination lacked jurisdiction to determine the tax for another taxable year.

In Gooch Milling & Elevator Co. v. *Commissioner, supra,* the majority of the court, in holding that the Board's jurisdiction extend to the case of an overpayment of a tax for one year when the taxpayer was contesting before the Board a deficiency covering a different year, ran counter not only to the decisional authority but also to the unambiguous terms of the statute. While the majority of the court in that case paid lip service to the express statutory prohibition that the Board of Tax Appeals shall have no jurisdiction to determine whether or not the tax for any taxable year, other than the year for which it is redetermining an asserted deficiency, has been overpaid or underpaid, it nevertheless directed the Board to offset the deficiency for the year before it by the amount by which the taxpayer had overpaid its taxes

for another year. We submit that since the Tax Court's jurisdiction extends only to the year for which a deficiency has been asserted by the Commissioner, the decision of the majority of the court in the *Gooch Milling Company* case is incorrect and that the Tax Court has no jurisdiction to allow recoupment of taxes paid for another year, regardless of any particular circumstances relating to such taxes or whether or not the overpayment of such taxes is admitted.

CONCLUSION

The decision of the Tax Court is correct and should be affirmed. The deficiency resulting should not be reduced by permitting recoupment for taxes paid for a year not before the Tax Court.

Respectfully submitted.

SAMUEL O. CLARK, Jr.,
Assistant Attorney General.
SEWALL KEY,
SAMUEL H. LEVY,
ARTHUR MANELLA,
Special Assistants to the Attorney General.

MAY 1943.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) *Losses by individuals.*—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

(1) if incurred in trade or business; or

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; or

(3) of property not connected with the trade or business, if the loss arises from fires, storms, shipwreck, or other casualty, or from theft. No loss shall be allowed as a deduction under this paragraph if at the time of the filing of the return such loss has been claimed as a deduction for estate tax purposes in the estate tax return.

(f) *Losses by corporations.*—In the case of a corporation, losses sustained during the taxable year and not compensated for by insurance or otherwise.

* * * * *

SEC. 272. PROCEDURE IN GENERAL.

(a) *Petition to Board of Tax Appeals.*—If in the case of any taxpayer, the Commissioner determines that there is a deficiency in respect of the tax imposed by this title, the Commissioner is authorized to send notice of such deficiency to the taxpayer by registered mail. Within ninety days after such notice is mailed (not counting Sunday or a legal holiday in the District of Columbia as the ninetieth day), the taxpayer may file a petition with the Board of

Tax Appeals for a redetermination of the deficiency. * * *

*   *   *   *   *

(g) *Jurisdiction over other taxable years.*—The Board in redetermining a deficiency in respect of any taxable year shall consider such facts with relation to the taxes for other taxable years as may be necessary correctly to redetermine the amount of such deficiency, but in so doing shall have no jurisdiction to determine whether or not the tax for any other taxable year has been overpaid or underpaid.

*   *   *   *   *

SEC. 322. REFUNDS AND CREDITS.

*   *   *   *   *

(d) *Overpayment found by Board.*—If the Board finds that there is no deficiency and further finds that the taxpayer has made an overpayment of tax in respect of the taxable year in respect of which the Commissioner determined the deficiency, the Board shall have jurisdiction to determine the amount of such overpayment, and such amount shall, when the decision of the Board has become final, be credited or refunded to the taxpayer. No such credit or refund shall be made of any portion of the tax unless the Board determines as part of its decision that it was paid within three years before the filing of the claim or the filing of the petition, whichever is earlier.

*   *   *   *   *

Revenue Act of 1942, Public Law No. 753, 77th Cong., 2d Sess.:

SEC. 504. CHANGE OF NAME OF BOARD OF TAX APPEALS.

(a) *The Tax Court of the United States.*—Effective on the day after the date of enactment of this Act, section 1100 (relating to status of Board of Tax Appeals) is amended by inserting at the end thereof the following new sentence:

"The Board shall be known as The Tax Court of the United States and the members thereof shall be known as the presiding judge and the judges of The Tax Court of the United States."

(b) *Powers, tenure, etc., unchanged.*—The jurisdiction, powers, and duties of The Tax Court of the United States, its divisions and its officers and employees, and their appointment, including the designation of its officers, and the immunities, tenure of office, powers, duties, rights, and privileges of the presiding judge and judges of The Tax Court of the United States shall be the same as by existing law provided in the case of the Board of Tax Appeals. * * *

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Art. 23 (e)–3. *Loss of useful value.*—When, through some change in business conditions, the usefulness in the business of some or all of the capital assets is suddenly terminated, so that the taxpayer discontinues the business or discards such assets permanently from use in such business, he may claim as a loss for the year in which he takes such action the difference between the basis (adjusted as provided in section 113 (b) and articles 113 (a) (14)–1, 113 (b)–1, and 113 (b)–2) and the salvage value of the property. This exception to the rule requiring a sale or other disposition of property in order to establish a loss requires proof of some unforseen cause by reason of which the property has been prematurely discarded, as, for example, where an increase in the cost or change in the manufacture of any product makes it necessary to abandon such manufacture, to which special machinery is exclusively devoted, or where new legislation directly or indirectly makes the continued profitable use of the property impossible. This exception does not extend to a case where the useful life of property terminates solely as a result of those gradual processes for which depreciation allow-

ances are authorized. It does not apply to inventories or to other than capital assets. The exception applies to buildings only when they are permanently abandoned or permanently devoted to a radically different use, and to machinery only when its use as such is permanently abandoned. Any loss to be deductible under this exception must be fully explained in the return of income. The limitations provided in section 117 with respect to the sale or exchange of capital assets have no application to losses due to the discarding of capital assets.

If the depreciable assets of a taxpayer consist of more than one item and depreciation, whether in respect of items or groups of items, is based upon the average lives of such assets, losses claimed on the normal retirement of such assets are not allowable inasmuch as the use of an average rate contemplates a normal retirement of assets both before and after the average life has been reached and there is, therefore, no possibility of ascertaining any actual loss under such circumstances until all assets contained in the group have been retired. In order to account properly for such retirement the entire cost or other basis of assets retired, adjusted for salvage, will be charged to the depreciation reserve account, which will enable the full cost or other basis of the property to be recovered.

In cases in which depreciable property is disposed of due to causes other than exhaustion, wear and tear, and normal obsolescence, such as casualty, obsolescence other than normal, or sale, a deduction for the difference between the basis of the property (adjusted as provided in section 113 (b) and articles 113 (a) (14)–1, 113 (b)–1, and 113 (b)–2) and its salvage value and/or amount realized upon its disposition may be allowed subject to the limitations provided in the Act upon deductions for losses, but only if it is clearly evident that such disposition was not contemplated in the rate of depreciation.

In the case of classified accounts, if it is the consistent practice of the taxpayer to base the rate of depreciation on the expected life of the longest lived asset contained in the account, or in the case of single item accounts if the rate of depreciation is based on the maximum expected life of the asset, a deduction for the basis of the asset (adjusted as provided in Section 113 (b) and articles 113 (a) (14)–1, 113 (b)–1, and 113 (b)–2) less its salvage value is allowable upon its retirement. (See articles 23 (1)–1 to 23 (1)–10.)

Art. 23 (f)–1. *Losses by corporations.*—Losses sustained by domestic corporations during the taxable year and not compensated for by insurance or otherwise are deductible except in so far as not prohibited or limited by sections 23 (g), 24 (a) (6), 112, 117, 118, and 251. The provisions of articles 23 (e)–1, 23 (e)–2, 23 (e)–3, 23 (e)–4, 23 (e)–5, and 23 (h)–1 are in general applicable to corporations as well as individuals. See section 232 as to deductions by foreign corporations.

U. S. GOVERNMENT PRINTING OFFICE: 1943